Monthly House Views

Dodging the puddles

Developed economies hit a soft patch in growth in Q1 2018. In part, seasonal factors are to blame – such as snowstorms in the US and the UK – but protectionist rhetoric has also raised concerns that last year's improvement in global trade might not last. On the other hand, growth drivers remain broadly supportive in the eurozone, the US is receiving a sizeable stimulus from sharply lower tax rates while many emerging economies will benefit from the pick-up in commodity prices.

As highlighted in recent quarters, fears of deflation have been banished as price indices have begun to recover in the US and in Europe. Indeed, households and investors have begun to expect that recent upward pressure will persist. In the US and the UK, core inflation has reached central bank target rates recently. All in all, we expect a steady rise in prices over the next twelve months.

Given our constructive macro scenario and the steady rise in inflation, we anticipate that central banks will continue their path of gradual normalization of policy. In the US, at least two further hikes are planned this year while the Fed continues to shrink its portfolio of securities. We expect that the ECB will have ended its asset purchases by year-end, setting the stage for a first hike in rates by mid-2019.

Risk assets such as equities face a number of short-term headwinds – the soft patch in activity, upward pressure on bond yields, potential regulatory challenges in IT and geopolitical uncertainties. In the longer-term however, the macro cycle backdrop remains supportive. In this context, we maintain the more neutral stance adopted a couple of months ago.

More details inside...

2 to 3 – Our views summarized

4 to 7 – The longer read

In accordance with the applicable regulation, we inform the reader that this material is qualified as a marketing document.

Our views summarized

EQUITIES BONDS ALTERN.

Here, we present our VaMoS investment approach, combining economic, valuation, momentum and sentiment signals that help us fine-tune our views on asset classes for the coming period. The signals below reflect the latest conclusions of our Global Investment Committee. Here's how to read them:

Least preferred Neutral Most preferred Upgrades in green, downgrades in red

EQUITIES		VA			MO		S	
		Valuation	Fundam.	Macro.	Momentum	Technicals	Sentiment	Risk
United States								
Eurozone								
UK								
Switzerland								
Japan								
Emerging								

BONDS	EUR Global	VA	MO	S
Sovereign				
Inflation-linked				
Inv. Grade				
HY				
*Duration**	Short			

BONDS	USD Global	VA	MO	S
Sovereign				
Inflation-linked				
Inv. Grade				
HY				
*Duration**	Short			

BONDS	GBP Global	VA	MO	S
Sovereign				
Inflation-linked				
Inv. Grade				
HY				
*Duration**	Short			

CURRENCIES	
EUR/USD	
GBP/USD	
USD/JPY	
EUR/CHF	
Emerging vs USD	

ALTERNATIVES	
Hedge funds	
Gold	
Oil	

Source: SG Private Banking, 04/05/2018, * Duration: short = 3 to 5 years, medium = 5 to 7 years, long = 7 to 10 years. HY = High Yield bonds (higher return but greater risks), Inv. Grade = Investment Grade bonds (higher quality but lower return)

In other words

EQUITIES*	United States	Earnings growth is strong but the corporate tax boost is already priced in, margins are likely to be pressured by rising wages and higher rates should hurt this expensive market. We remain slightly underweight within a global equity portfolio.
	Europe	Corporate earnings will remain supported by the global economic recovery but gains will be slower. Softer growth and Brexit concerns will leave investors nervous.
	Eurozone	Although corporate profits growth is slower, we stay neutral as recent euro weakness should also ease pressure on multinationals, while rising global rates will support Financials, the largest sector in European indices.
	UK	We remain cautious on UK equities given the ongoing economic slowdown and still high Brexit uncertainty.
	Switzerland	Although a weaker franc is good for multinationals, corporate earnings forecasts have been revised down in recent months. We stay neutral.
	Japan	Despite short-term headwinds (trade tensions, political risks), Japanese firms benefit from above-potential growth, ultra-accommodative monetary policy, reasonable valuation and structural reforms resulting in better governance and profitability. We remain positive.
	Emerging	Despite still robust earnings growth, improved profitability and higher oil prices that benefit commodity producers, headwinds remain plentiful (China slowdown fears, Fed rate hikes and rising global yields, trade tensions, and a stronger dollar), warranting a neutral stance.
BONDS*	Sovereigns	US long-term yields will be lifted by the impact of the rising fiscal deficit on growth, inflation and debt issuance.
	Duration**	Short maturities should be favoured as rates continue to rise.
	Inflation-linked	Signs of price pressure reinforce our positive stance on inflation-linked bonds.
	Investment Grade	In the US, we would refrain from adding risk – corporate leverage is high and tightening financing conditions will lead to greater risk of default. In this context, we still favour Investment Grade bonds over High Yield.
	High Yield	In the eurozone, High Yield should continue to outperform Investment Grade bonds in 2018.
	Emerging debt (in € and $)	Emerging debt is feeling the pain of higher but sustained growth in the US and good policy management will support the asset class.
CURRENCIES	EUR/USD	The euro should weaken in the short term, although we remain constructive in the longer term.
	GBP/USD	Sterling vulnerabilities persist driven by politics, an economic slowdown and a large current account deficit.
	EUR/GBP	We foresee a gradual appreciation in the euro underpinned by the growth differential.
	USD/JPY	The yield gap favours the dollar at the moment, but the yen should become less undervalued.
	EUR/CHF	The Swiss franc is set to remain on a downtrend as the currency remains sharply overvalued and key interest rates should stay negative.
	Emerging	The stronger dollar is a headwind but solid fundamentals and appealing carries are powerful counterforces.
ALTERNAT.	Hedge funds	Neutral overall, with a marked preference for Merger Arbitrage and Market Neutral, given the tax-cut driven boom in takeovers and the rise in volatility.
	Gold	Trade war concerns, Middle East tensions and financial market volatility could underpin gold prices. Despite some headwinds, we still view gold as a good diversifier, its safe-haven behaviour helping mitigate drawdowns and reduce volatility within portfolios.
	Oil	Despite the recent rally, we expect Brent oil prices to ease back towards $65 by year-end with supply growing faster than demand.

Source: SG Private Banking, 04/05/2018, EM = Emerging markets, hard currency = dollar & euro, *Relative views expressed in local currencies, ** Duration: short = 3-5yr, medium = 5-7yr, long = 7-10y

Economic focus

How soft a soft patch?

- After accelerating throughout 2017, growth has slowed since the start of the year.
- We expect the US yield curve to steepen again as tax cuts boost activity in the US.
- In Europe, surveys suggest robust capital expenditure this year.
- We conclude that the Q1 soft patch is unlikely to derail global growth momentum.

- Since the start of 2018, business and consumer confidence reports have suggested slower growth in activity after last year's marked acceleration. In recent weeks, various countries have published disappointing growth figures for the first quarter. Is this a "pause which refreshes" or the early-warning sign of impending recession?

Some economies have lost momentum

- Confidence had reached unsustainable highs late last year, as described in the editorial of our Q2 House Views, *Bumps in the Road*. A reversal to less exuberant levels should have come as no surprise.
- This being said, European Central Bank (ECB) president Mario Draghi did highlight a *"loss of momentum that is pretty broad-based across countries and all sectors"* in his recent press conference.
- The weakness in some developed economies – notably the US and the UK, where snowstorms disrupted output, and France – has not been uniform and has gone hand in hand with strength in some emerging economies. In the west, there have been bright spots – Spain for example saw 0.7% QoQ growth, unchanged from the second semester 2018 – while China again defied expectations of a slowdown, registering 6.8% YoY growth in Q1.

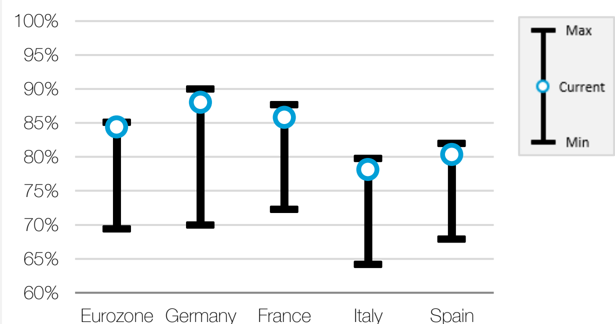
But there have been signs of recovery

- Within the eurozone, recent weeks have brought some signs that activity is stabilizing. The fall in April's PMI manufacturing survey was less pronounced than expected, with sentiment slightly lower in Germany and slightly higher in France. In the US, manufacturing confidence remains high – the ISM survey eased to 57.3 while the PMI series increased to 56.5, in both cases well above the 50 level which marks economic expansion.

- The European Commission's economic sentiment survey for April was also rather encouraging. Eurozone industry confidence edged up on the back of improved production expectations, as did consumer confidence, reflecting optimism about falling unemployment. Last year's acceleration in activity has pushed capacity utilisation close to multi-decade highs (see chart below), a possible constraint on growth this year. In reaction, manufacturers plan to boost investment. According to the survey, the expected rate of increase in real investment in 2018 is now 7%, up from 4% in the previous survey last autumn.

Manufacturing capacity close to highs

Capacity utilisation in manufacturing industry



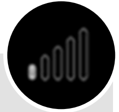
Sources: Societe Generale Private Banking, European Commission, April 2018.

- Another preoccupation for investors has been the flattening in the US yield curve, i.e. the difference between 2- and 10-year rates. It should be borne in mind that while every recent US recession has been preceded by an inverted yield curve, not every inversion has led to recession. And as you will read on the next page, we see further upside in US rates, meaning renewed steepening in the curve. With tax cuts set to boost activity this year, the inevitable US recession is not yet on the cards.

Conclusion

- The soft patch in the first quarter of 2018 is unlikely to derail global growth.

Fixed Income



US yields – On the rise

- US yields are set to move higher but only by phases.
- Inflation-linked securities still provide good diversification.
- Widening of corporate spreads to remain contained.
- We still favour short maturities.

Rates

US interest rates to grind higher

- United States. 10-year Treasury yields broke above 3% for the first time since 2014. Although we see further upside, the gradual rise in inflation should encourage the US Federal Reserve (Fed) to move slowly. We except two more rate hikes this year as corporate tax cuts start boosting growth and inflation. The yield curve – measuring the gap between 2- and 10-year yields – has flattened but we do not expect it to invert, often an early sign of economic downturn. Despite the recent rise, inflation break-evens remain well below their long-term average and we think the market remains too complacent. This suggests keeping bond maturities short in the context of a rather flat yield curve.
- Eurozone. In the wake of the US, core sovereign bond yields have risen to a higher trading range. In our view, the eurozone market is still widely overvalued and interest rate risks are significant, given that ECB asset purchases are set to decrease. Peripheral bonds still offer value as those economies improve, credit conditions are getting easier and ratings upgrades are expected. However, we do not expect a rate hike before well into 2019 as core inflation has been stubbornly weak below 0.7%. We only expect a gradual rise in inflation and keep exposure to index-linked bonds.
- United Kingdom. Despite upward pressure from the rise in global yields, the upside to UK rates will be capped by receding inflation and slower long-term growth.

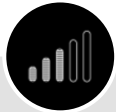
Credit

Modest spread widening a proof of resilience

- United States. Corporate spreads have moved away from their February lows following a series of healthy economic indicators and a good Q1 earnings season. We still prefer Investment Grade (IG) to High Yield (HY) as the latter could be weakened by rising rates and a more volatile equity market. We also favour floating-rate notes which offer a good hedge against rising rates and help reduce portfolio duration.
- Eurozone. Eurozone credit remains underpinned by sustained growth, ECB asset purchases and attractive carry. Corporates have made further efforts to reduce leverage and improve interest coverage ratios. The ECB asset purchase scheme will remain a positive in coming months as it will only be halted in late 2018. We prefer corporate hybrids, subordinated financial debt and selected floating-rate notes that offer higher carry. For the year ahead, we expect HY to outperform IG, as tight spreads mean higher sensitivity to rising rates
- Emerging debt. Higher US rates and a stronger dollar have been major headwinds for emerging debt. Given we could see more of the same in the short run, investors should be braced for greater volatility. However, many emerging countries have improved fundamentals and we do not expect the reduction in asset purchases to wreak havoc as in 2013. We still see value in emerging debt but would stay away from the weakest issuers or those heavily dependent on dollar inflows.

Sources: SGPB, Bloomberg, 01/05/2018. Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

Equities



Not much to go for

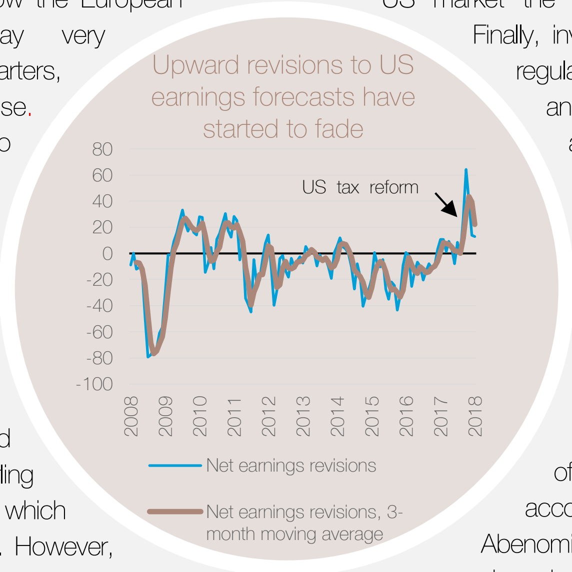
- Despite trade tensions, geopolitical risks and fears of tighter regulation in US tech and internet (both on data privacy and market concentration), global equities have recovered since end-March and volatility is fading.
- Year-to-date, global equity markets are almost flat. The combination of slower growth in Q1 and rising US inflation and rates have raised doubts as to the durability of the current global economic expansion, which should keep stock markets volatile in the short run.
- The global economy will continue to expand at a slower but still solid pace in coming months. This bodes well for strong corporate profit growth and very gradual monetary policy tightening.

Stay neutral on global equities

Recent euro weakness to help eurozone equities take a breather

Tax boost to US profits already largely priced in

- Eurozone. Earnings-per-share (EPS) growth forecasts have been revised down in response to the euro's sharp rise last year and to the decline in business sentiment indicators in past months. Profit growth in the eurozone should underperform other regions – the IBES consensus is +6.9% for the EuroStoxx this year after a strong 14.4% in 2017. However, despite weaker economic activity in Q1, domestic demand is still robust and growth remains above potential. Moderate inflation will allow the European Central Bank (ECB) to stay very accommodative in coming quarters, keeping financing conditions loose. Recent euro weakness should also ease pressure on multinationals, while the surge in oil prices will benefit commodity-related sectors and rising global rates will support Financials, the largest sector in European indices. All in all, we stay neutral on eurozone equities.
- UK. UK equities have rebounded since end-March on the back of sterling weakness and higher oil prices, which boosted commodity-related sectors. However, we would remain cautious on UK equities given the ongoing economic slowdown and still high Brexit uncertainty.
- Switzerland. After a sharp rise last year, corporate earnings forecasts have been revised down in recent months and price momentum has faded. Although a weaker franc is good for multinationals, the Swiss market will struggle to benefit from the global growth expansion given its heavy exposure to defensive stocks. All in all, we stay neutral.



- USA. Despite a strong start to the Q1 earnings season – S&P 500 companies reported EPS growth of 23.3% YoY, beating estimates by 7.2% – the US market has under-performed its developed peers since end-March. In effect, strong earnings are already priced in, margins are likely to be pressured by rising wages and funding conditions will be less supportive given rising US rates. Furthermore, despite the sell-off valuations remain unattractive with the US market the most expensive among peers. Finally, investors fear protectionism, tighter regulation in internet and technology and softer economic growth in Q1 in a context of rising rates. All in all, we stay slightly underweight within a global equity portfolio.
- Japan. Despite short-term headwinds, Japanese firms benefit from a supportive economic context: above-potential growth and tame inflation will encourage the Bank of Japan to keep an ultra-accommodative stance. Moreover, Abenomics have helped Japanese companies improve their governance and profitability, a structural tailwind. We remain positive.
- Emerging markets. After a strong 2017, corporate profits are expected to grow at a slower but still robust pace this year. In addition, margins and return-on-equity have improved steadily since mid-2016 and valuations remain attractive. In addition, higher oil prices have benefited commodity producers. However, headwinds remain plentiful in emerging markets (China, Fed, trade tensions, and a stronger dollar), warranting a neutral stance.

Sources: SGPB, Datastream, 02/05/2018. Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

Currencies

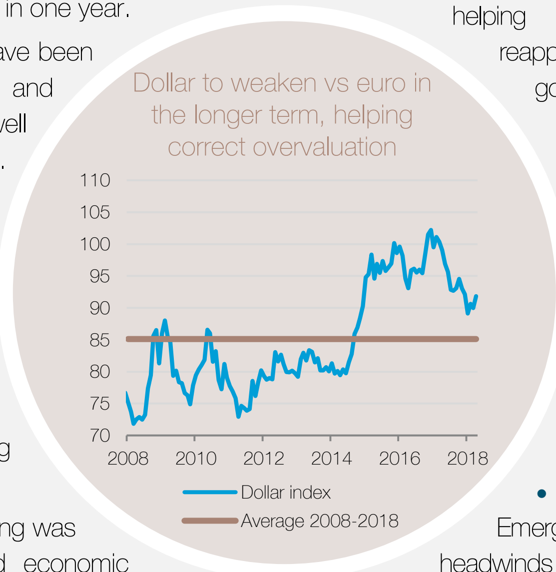
Temporary boost to the dollar

- The dollar will be underpinned by rising yields in the short run. However, we remain bearish in the longer term.
- Despite disappointing eurozone growth data, we are still bull euro.
- We stay neutral sterling although risks remain to the downside.
- High yields and solid macroeconomic fundamental should protect emerging currencies from dollar strength.

Strong dollar momentum

Yield gap back in the driving seat

- Euro – structural supports. Various factors have pushed the euro lower against the dollar. First, recent eurozone confidence and activity data have missed expectations. Second, ECB policy remains very accommodative with no indication as to when asset purchases might stop. Cyclical factors will continue to underpin the dollar in the short run. As a result, EUR/USD could break further below 1.20. However, structural supports encourage us to stay positive euro, targeting 1.30 in one year.
- Dollar – cyclical revival. US yields have been driven higher by wage pressure and economic activity remains well supported despite Q1's soft patch. While stronger Fed rate hike expectations are a support, there are also headwinds – tax cuts will deepen the budget deficit and boost imports, deepening external deficits. All in all, we expect the dollar to lose ground versus the euro in the longer term, helping correct its overvaluation.
- Sterling – headwinds. In 2017, sterling was supported by a softer dollar and economic resilience, to such an extent that it had returned to pre-Brexit vote levels by early 2018. However, there are still downside risks – we forecast softer growth in the short and medium term while falling inflation might postpone the next rate hike. Despite the headwinds, we remain neutral – sterling is modestly undervalued and the Bank of England still plans to normalise policy.



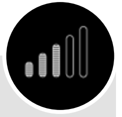
Emerging currency resilience

Emerging currencies should benefit from high yields and dollar weakness

- Swiss franc – edging lower. With risk appetite back, the franc has eased lower. Of course, any bout of volatility could boost it short-term. However, rate hikes are unlikely anytime soon with the currency still strongly overvalued. This should help the Swiss franc weaken gradually and we revise our one-year forecast for EUR/CHF to 1.25.
- Yen – weak for now. After a period of fast appreciation, the yen weakened again in April with the widening yield gap helping the dollar outperform. The reappointment of Mr. Kuroda as governor of the Bank of Japan suggests policy will remain easy. However, sustained growth and rising wage pressures have driven inflation modestly higher – this should support the yen as markets begin to price in a policy shift. We remain neutral yen in the near term but expect it to strengthen later this year. We target 105 in one year.
- Emerging currencies – keep faith. Emerging currencies are facing headwinds with rising US rates leading to a stronger dollar. However, the pick-up in commodity prices is a windfall for commodity-related currencies. Overall, we expect emerging currencies as a whole to withstand the stronger dollar thanks to strong fundamentals and an attractive yield gap. Prudent monetary policies aiming at balancing external competitiveness and inflation risks are now essential. As we expect the dollar bounce to be rather short-lived, high-carry emerging currencies should continue to do well.

Sources: SGPB, Bloomberg, 30/04/2018. Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

Alternatives



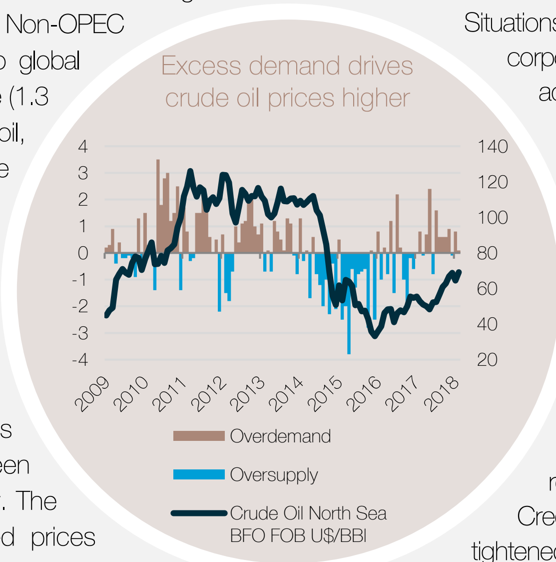
Trend reversals

- Despite the recent rally, we expect Brent oil prices to ease back towards $65 by year-end with supply growing faster than demand.
- Higher volatility boosts Market Neutral strategies, while the takeover boom is underpinning Merger Arbitrage funds.
- Tighter spreads mean little opportunity for Credit managers, while the emergence of early-stage trends looks promising for Commodity-Trading Advisors (CTAs).

Commodities

"Disruption in Venezuela and output quotas have reduced supply year-to-date"

- Crude oil. Geopolitical tensions and healthy demand have lifted Brent prices to $75. Recent data from the International Energy Agency (IEA) suggest that Q1 demand beat expectations in the OECD but disappointed elsewhere. The agency still predicts global demand to grow by 1.5 million barrels/day (mb/d) this year – a cold winter has supported US consumption and tax cuts should boost oil imports. Meanwhile, OPEC output was weaker in March due to disruption in Venezuela and the Middle East and greater compliance with the quotas. Non-OPEC countries should add 1.8 mb/d to global production this year. Most of the rise (1.3 mb/d) will come from US shale oil, following strong investment and the enhancement of drilling techniques. Despite the recent rally, we expect Brent prices to ease back towards $65 by year-end with supply growing faster than demand.
- Gold – dollar-driven. Despite geopolitical tension, gold prices have remained stuck between $1,300 and 1,360 so far this year. The recent dollar bounce has pushed prices towards the lower end of this range. Gold ETFs saw $1.3bn inflows in Q1 – Asia and Europe recorded outflows but North America saw significant purchases. Trade war concerns, Middle East tensions and financial market volatility could underpin gold prices. Despite some headwinds (dollar strength, rising bond yields, subdued inflation), we still view gold as a good diversifier, its safe-haven behaviour helping mitigate drawdowns and reduce volatility within portfolios.



Hedge funds

"With no sign of a pick-up in defaults, opportunities for Distressed Debt are unlikely to improve"

- Equity Long/Short. The tailwinds for active managers continue to blow, with a majority outperforming benchmarks. However, market reaction to the quality of Q1 earnings reports has been muted so far, suggesting a neutral stance for Equity Long/Short is warranted. Market Neutral funds – which aim for low sensitivity to directional moves – look attractive, as higher volatility means less need for leverage.
- Event Driven. The backdrop remains supportive for Special Situations funds, with US tax cuts boosting corporate activity. In particular, takeover activity has benefited, with $1.7tn of deals announced so far this year, the most since 2007. In addition, spreads have widened – thanks to higher volatility and the questionable logic of some deals – which improves the opportunity set for Merger Arbitrage specialists.
- Credit/Distressed Debt. As equity markets have begun to recover from the recent sell-off, Credit spreads in high yield have tightened modestly again, but return potential remains limited. And with no sign of a pick-up in defaults, the opportunity set for Distressed Debt specialists is unlikely to improve in the near term.
- Global Macro/CTAs. In recent weeks, a number of trends have emerged – e.g. the rallies in the dollar and European equities – and CTAs have begun to build new positions, after deleveraging in March and early April. These fresh trends have further to run, suggesting a more neutral stance. Global Macro managers will take more time to rebuild positions, meaning better opportunities elsewhere.

Sources: US EIA, Bloomberg, 31/03/2018. Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

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